CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY

FOR
DIRECTED BROKERAGE ARRANGEMENT

~~April 14, 2006~~June 16, 2006

This Policy is effective immediately upon adoption and supersedes all previous directed brokerage policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for Directed Brokerage Arrangement ("Arrangements"). The design of this Policy ensures that investment managers or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while participating in the Arrangements. Additionally, use of this Policy provides assurance that there is sufficient flexibility to obtain goods and services necessary for the prudent management of the fund while adhering to all regulatory standards.

II. STRATEGIC OBJECTIVES

The strategic objective of the Arrangements is to maximize the funds available for investment research, analysis, analytical tools and transaction services by implementing industry accepted practices related to the recapture of commissions paid by the System to brokers.

III. RESPONSIBILITIES AND DELEGATIONS

A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Investment Committee delegates the responsibility for administering the Arrangement to the Fiscal Services Staff through the Delegation of Authority (Delegation No. 95-101).

B. The **System's Fiscal Services Staff** ("the Fiscal Staff") shall be responsible for:

1. Implementing and adhering to the Policy;

2. Maintaining a procedure manual subject to periodic reviews and updates that outline Fiscal Staff operational procedures;

3. Reporting immediately to the Investment Committee all violations of the Policy with explanations and recommendations;

4 Monitoring and reconciling commissions recaptured, and resolving variances between managers and brokers monthly;

5. Accounting for all funds generated from the Arrangements;

6. Preparing monthly external manager reports on commissions earned, and;

7. Maintaining records and reports of recaptured commissions.

C. The **System's Investment Office Staff** ("the Investment Staff") shall be responsible for:

1. Developing and recommending the Policy to the Investment Committee;

2. Contracting with external investment managers who will be required to direct a portion of their normal trading activity to brokers participating in the System's Arrangements, if in the System's best interest. Investment Staff shall include directed brokerage language in the external investment manager contracts and negotiate with each manager the terms of their participation in the Arrangements;

3. Evaluating and recommending the addition or removal of brokers from the Arrangements:

   a. Additions - The System shall authorize the use of brokerage firms that have expressed an interest in participating and that are deemed to add value and choice to the System's available brokerage firms. The brokerage firms must be capable of providing trade transactions on a "best execution" basis. Brokers shall be added pursuant to a written agreement between CalPERS and the brokerage firm initiated and approved by Investment Staff.

b. Removals – Removal from the Arrangements shall be based upon the Investment Staff's evaluation and recommendation, to include:

(1) The level of commissions generated, and;

(2) Relative ranking compared to other participating brokers.

4. Adhering to all of the System's standard procurement procedures when making purchases with recaptured commissions. In addition, the System's procedures require Senior Investment Officers to attest to SEC Section 28 (e) eligibility.

5. Reviewing the activities of CalPERS' external investment managers that are participating in the Arrangements to validate that:

a. A portion of their normal trading activity is being directed to a participating broker who is returning a percentage of its commission to the System, and:

b. The investment manager is using best efforts to obtain best price and execution for securities traded for CalPERS.

IV. GENERAL

A. Directed Brokerage Arrangement: A Directed broker Arrangement is an arrangement whereby investment manager trading is executed through a specific broker (or a list of participating brokers) for the benefit of the System. In exchange for having its investment managers direct trades to a specific broker, the System receives a benefit in addition to execution services. The benefit the System receives from its Arrangements is recaptured commissions. Other forms of Arrangements exist, however the System only utilizes the commission recapture Arrangement.

Commission recapture is an arrangement whereby investment managers hired by CalPERS that have an investment strategy conducive to, and a willingness to participate in the Arrangement, direct trades to CalPERS' list of participating brokers. The broker then returns a portion of its commission to CalPERS. Under this Arrangement, the broker does not directly pay CalPERS' obligations nor does CalPERS direct the investment manager to use a specific broker. In addition, CalPERS does not pay a higher commission rate than the investment manager's other clients as a result of the Arrangements.

B. **Use of Funds:** There are three criteria that must be met for recaptured commissions to receive the protection afforded by Section 28(e) of the Securities Exchange Act of 1934. At the direction of the Board, the services acquired from its Arrangements must adhere to these criteria. Services must be "brokerage and research" services, defined as follows:

- Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in purchasing or selling securities, and the availability of securities or purchasers or sellers of securities;

- Furnishing analyses and reports concerning issues, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts; or

- Effecting securities transactions and performing functions incidental thereto ~~(~~such as clearance, settlement and custody~~)~~, or required in connection therewith by rules of the SEC or a self-regulatory organization of which such a person is a member or person associated with a member or in which such a person is a participant.

~~It is important to note that computer hardware and software related to investment research falls within the provisions of Section 28(e).~~ Services not protected by the provisions of Section 28(e) include computer hardware, professional licensing fees and general office overhead expenses. ~~considered as not providing "lawful and appropriate assistance to the investor in the performance of its investment decision-making responsibilities" such as newspapers, magazines, periodicals, government publications, office equipment, and so forth, are not protected by Section 28(e); therefore~~ Therefore, they cannot be purchased using commissions recaptured as part of the System's Arrangements.

V. POLICY

The System recognizes that the generation of commissions is inherent to the trade execution function of the investment process. Arrangements are a widespread industry practice to recover, recapture and use a portion of commissions generated by normal trade activity to defray expenses associated with portfolio management.

A. Commission Recapture

The participating broker will transfer the recaptured commission to the System in accordance with their agreement with the investment manager. These funds shall be deposited into the Public Employee's Retirement Fund (PERF) in a portfolio maintained by the master custodian. The recaptured commissions received will be tracked by Fiscal Services staff and reported to the Finance Committee.

B. External Participants

1. Determining External Manager Participation

The Investment Staff shall determine which external investment managers will participate in the Arrangements. The managers shall be selected in accordance with the Board's Contract and Procurement Policies. Factors included in determining the most qualified investment managers are as follows:

a. Best Execution

The ability of a manager to achieve best execution is the most important factor in the investment Staff's analysis. The costs associated with executing a trade are both implicit and explicit. The explicit cost is the commission cost associated with administering the trade (brokerage charge, stamp-tax, SEC charge, etc). Implicit costs are market impact costs and opportunity costs. The implicit costs are not transparent to a fund and difficult to measure and monitor on an ongoing basis.

b. Manager's Investment Strategy

A manager's investment strategy may or may not, lend itself to the Arrangements without jeopardizing best execution. For example, active equity and enhanced index managers as well as those that execute a large number of program or principal trades are not good candidates for participation in the Arrangements due to their trading strategies. Also, managers that trade certain types of securities such as small cap securities, emerging markets securities, thinly traded securities or trades on less liquid international exchanges generally do not participate in the Arrangements.

Managers with value and growth strategies are more deliberate in their trading and are more price sensitive in their buy and sell decisions. Both of these general practices make them good candidates for participation in the Arrangements.

The list of CalPERS' participating brokers is sufficient to provide the majority of external investment managers the ability to identify a number of brokers to utilize.

c. Manager's Level of Participation in Other Clients' Directed Commission Programs

If a manager is not participating in Arrangements for other clients and is forced to do so only for CalPERS, there is a risk of disrupting the manager's trading style and process. Forcing a manager to direct trades on behalf of CalPERS when the manager does not direct for others is potentially detrimental to CalPERS' execution because the other clients' trades will be placed first in the queue to be executed. If CalPERS' trades will be placed second in the queue, less than desirable execution will result since the market will have likely been impacted by the first trade.

2. Managers - Reporting

The System's external investment managers shall be required to submit a monthly report to the System's Fiscal Services Division and Investment Office no later than the

15th of the following month. This report shall be for all activity in the previous calendar month, directed brokerage commissions and all other commissions. Managers shall pre-reconcile with brokers prior to reporting to the System.

3. Brokers - Reporting

The System's participating brokers shall submit a monthly report to the System's Fiscal Services Division and the Investment Office no later than the 15th of the following month. This report shall be for all activity in the previous calendar month, commissions recaptured and all other commissions. Brokers shall pre-reconcile with investment managers prior to reporting to the System.

4. Broker Termination

CalPERS' written agreements with its participating brokers may be terminated at any time, by either party, upon written notice, for any reason. Upon receipt of a termination notice, the broker shall promptly discontinue all services affected unless the notice specifies otherwise.

All duties and obligations of CalPERS and the broker shall cease upon termination of the written agreement between them, with the exception that each party shall remain liable for any rights, obligations, or liabilities arising from activities carried on by it under the agreement prior to the effective date of termination. Brokers will be required to remit any balance due to CalPERS within thirty (30) calendar days following termination.

Approved by the Policy Subcommittee: December 14, 2001
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